

sheer energy inc.

1998 Annual Report

Sheer Energy Inc. is an oil and gas exploration and production company. Eighty percent of the Company's revenues are generated from gas production, with approximately one-half of all gas revenue being derived from an interest in the South Edson Gas Unit No. 1.

The Corporation is continuing to seek low risk development opportunities within Western Canada and internationally.

FINANCIAL SUMMARY

Year ended December 31	1998	1997
Total Revenue	\$ 325,995	\$ 2,930
Funds Flow from Operations	121,344	283
Funds Flow from Operations per share	0.03	nil
Earnings (Loss)	(40,352)	(263)
Earnings (Loss) per share	(0.01)	nil
Capital Expenditures	624,038	nil
Business Acquisition	630,000	nil
Total Assets	\$ 1,307,281	\$ 214,943
Common Shares Outstanding	4,100,003	2,100,003

ANNUAL MEETING

The Annual and General Meeting of the Shareholders of Sheer Energy Inc. is to be held at 3:00 p.m., Tuesday, June 15, 1999 at Salon "C" of the Delta Bow Valley Hotel, 209 - 4th Avenue S.W., Calgary, Alberta.

CONTENTS

1	President's Message to Shareholders
2	Operations Review
4	Management's Discussion and Analysis
5	Auditors' Report
6	Consolidated Financial Statements
9	Notes to Consolidated Financial Statements
IBC	Corporate Information

president's message to shareholders

1998 was a significant year in the development of Sheer Energy Inc. The Corporation completed a public issue and was listed on the Alberta Stock Exchange as a Junior Capital Pool on April 6, 1998. The public offering consisted of 1,450,000 common shares at an issue price of \$0.20 per share.

Sheer made two acquisitions during the year, one of a private corporation, and the other of producing oil and gas assets, through a combination of cash, bank debt and the issuance of additional common shares. In September, Sheer completed its "major transaction", the acquisition of all of the issued shares of Krystal Energy Inc., a private exploration, development and production company. In November, Sheer acquired certain oil and gas assets from 747724 Alberta Ltd. in exchange for cash and 550,000 common shares of Sheer Energy Inc. at a deemed value of \$0.30 per share. Sheer ceased to be a Junior Capital Pool Corporation in the fall of 1998. On December 31, 1998, Sheer Energy Inc. and Krystal Energy Limited were merged to continue as Sheer Energy Inc.

Production for the year averaged just under 100 barrels of oil equivalent per day (BOE/day) with in excess of 80% being comprised of natural gas production. Sheer's year end production average was 819 Mcf/day of natural gas and 17 barrels per day of oil and natural gas liquids (NGL's) for a combined 99 barrels of oil equivalent per day. Given the state of crude oil markets throughout the year, management's decision to concentrate on gas production appears to have been prudent.

The acquisitions made during the year did not result in significant tax pools and as a result the Corporation is taxable at present. Management and the Board were aware of this circumstance and the value placed on the acquisitions was adjusted accordingly.

Shareholders should note that revenues from the Krystal acquisition accrued to Sheer beginning May 1, 1998 and those from the production acquisition on July 1, 1998. Therefore, the financial statements do not provide for a full year of revenues from either source.

OUTLOOK

We are pleased to note the improving outlook for crude oil and natural gas prices.

Certain non-recurring costs were incurred in 1998 with respect to the two acquisitions, the public share issue and exchange listing. We would expect that the combination of a full year of production from our properties, the elimination of non-recurring expenses, and improved product prices will result in improved financial performance.

Your management is continuing to pursue growth through acquisition and development and we fully expect 1999 to be an exciting year for your Corporation. Preliminary meetings and discussions have taken place with respect to participation by the Corporation in a "buy back" project in Iran. Evaluation of the prospect is currently under way; however, it should be noted that a definitive agreement has not yet been concluded.

We wish to thank our shareholders for their confidence and support.

On behalf of the Board,

Calgary, Alberta
May 3, 1999



T. D. Lawrence
President

operations review

An evaluation of the Corporation's properties acquired in November 1998 from 747724 Alberta Ltd. was recently completed by Fekete Associates Inc., reporting remaining recoverable reserves and net present values as at January 1, 1999. An independent evaluation of the properties acquired from Krystal Energy Limited will likely be completed by the end of May and will be reported in the first quarter report to the shareholders. The reason for the delay is that the values must be extracted from a larger evaluation of the properties of the operator. The Krystal properties consist of small working interests in approximately 250 wells, the majority of which are natural gas producers. We can report that approximately 43% of the current daily production of Sheer Energy is derived from the Krystal acquisition while 57% comes from the property acquisition from 747724 Alberta Ltd.

The Krystal wells produce 359 Mcf/d of natural gas and 6 barrels per day of crude oil and natural gas liquids net to Sheer's interest while the properties acquired from the numbered company produce 460 Mcf/d and approximately 11 barrels per day of crude oil and natural gas liquids net to the Corporation. As previously reported, in excess of 80% of the Corporation's revenues are generated from natural gas sales.

It is management's opinion that the remaining recoverable reserves from the Krystal properties will be in the order of 700,000 Mcf of natural gas and 5,000 barrels of oil and natural gas liquids, having a net present value at a 12% discount of approximately \$650,000.

Following is a brief description of the three major properties acquired from 747724 Alberta Ltd. It is worth noting that the 12% net present value of \$911,000 attributed by our engineering consultants, Fekete Associates Inc., to the proved plus probable reserves (probables risked at 50%) at January 1, 1999 is approximately 19% higher than the value of \$763,000 assigned by the same independent engineering firm as at July 1, 1998. The increase in value is due to improved natural gas prices and recent drilling activity in the South Edson Gas Unit.

SOUTH EDSON GAS UNIT NO. 1

Sheer has an 8.9668% working interest in the South Edson Gas Unit No. 1 located west of Edmonton. The Unit covers 45,120 gross acres of land and produces natural gas from the Elkton-Shunda formations at a rate of approximately 4,800 Mcf/d gross. Four wells are currently on production and four wells are shut-in or suspended. One additional well may be drilled during 1999 and a booster compressor may be installed in the next few years to reduce the flowing wellhead pressures and increase productivity. The new well and the compression facilities are forecast to increase production by 2,000 Mcf/d and 680 Mcf/d respectively. The 12% discounted cash flow value of proved reserves is \$535,000 while the probable, unrisked, would add another \$66,000 to the value of the property.

The South Edson Gas Unit represents over 60% of the value of the 747724 Alberta Ltd. acquisition.

SOUSA

Sheer has a 0.9059% working interest and a 1.1211% gross overriding royalty in the Sousa Bluesky/Gething Gas Unit located in North Western Alberta.

The Unit covers 72,320 gross acres and commenced production in 1982. There are a total of 19 wells in the Unit, of which 17 are producing and 2 are suspended. Current gross Unit production is 2,000 Mcf/d.

Although our consultants have not assigned any probable reserves to the Unit, it is feasible that, due to the large amount of undrilled acreage located some distance from current producers, additional drilling may be considered. The 12% discounted cash flow value of proved producing reserves within the unit is \$141,000 net to Sheer's interests.

PINE CREEK

Sheer has a 5.7612% working interest in the Pine Creek Second White Specks "A" Pool Unit located to the West of Edmonton. Production commenced in early 1993 from the "A" pool. Three wells are currently on production and three wells are suspended. Gross Unit production is comprised of 63 barrels of oil per day, 200 Mcf/d of gas and 11 barrels of natural gas liquids. The 12% discounted cash flow value for the proved producing reserves within the Unit is calculated at \$125,000 net to Sheer's interest.

MINOR PROPERTIES

Sheer also acquired minor working interest in three other oil Units from the numbered company. They are: Cynthia Cardium Unit No. 4 which currently produces 130 barrels of oil per day; Snipe Lake Beaverhill Lake Unit No. 1 which currently produces 1,760 barrels of oil per day; and the Wainwright Unit No. 6 which currently produces 205 barrels of oil per day. Sheer's working interest in these three units ranges from 0.076% (Snipe Lake and Wainwright) to 0.32% (Cynthia). Combined 12% discounted cash flow value for proved producing reserves, net to Sheer, is approximately \$40,000.

management's discussion and analysis

FINANCIAL RESULTS

The 1998 fiscal year for Sheer Energy comprised the start-up of the Corporation as a public entity and recognized the first production revenues from acquisitions made during the year. Consequently, comparative figures for the preceding year are not meaningful. Barrels of oil equivalent (BOE) are calculated using a 10:1 conversion ratio for natural gas.

PRODUCTION VOLUMES AND REVENUES

Production volumes are based on the daily production which resulted in revenues to the account of Sheer Energy. The total net production to the account of the Corporation in 1998 was 20,804 BOE.

	12 months ended December 31, 1998	
Oil and Gas Revenue	\$	\$ per BOE
Petroleum and Natural Gas	390,297	18.76
Royalties net of ARTC	(69,422)	(3.34)
Interest	5,120	0.25
	325,995	15.67
Operating Costs	106,772	5.13
General & Administrative	81,324	3.91
Interest	11,267	0.54
Income Taxes	25,252	1.21
Funds from Operations	101,380	4.88

Royalty costs, net of ARTC were \$3.34/BOE. Most of the properties acquired from the numbered company are not eligible for ARTC while all of the Krystal interests are eligible for ARTC.

Operating costs of \$5.13/BOE are well within industry averages and G&A costs of \$3.91/BOE are quite acceptable, given the current stage of development and should be reduced with a complete year of operating income.

The depletion and amortization provision was \$141,732 or \$6.81/BOE.

The future site restoration provision of \$19,964 in 1998 is deemed to be adequate at December 31, 1998. Further provisions are anticipated in the 1999 fiscal year.

Income taxes of \$25,252 (\$1.21/BOE) were provided for 1998.

Cash flow from operations was \$121,344 or \$0.03 per share. The Corporation incurred a loss of \$40,352 in 1998 or \$0.01 per share.

Shareholders should note that at present the Management and Directors are not being compensated for their services in either capacity. Management believes that it is in the best interests of all shareholders that available cash flow be directed to the identification of additional opportunities which will ensure growth and the enhancement of shareholder value.

auditors report

To the Shareholders of

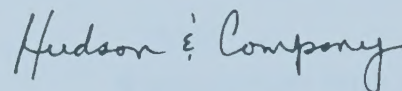
Sheer Energy Inc.

We have audited the consolidated balance sheets of Sheer Energy Inc. as at December 31, 1998 and 1997 and the consolidated statements of earnings and retained earnings (deficit) and cash flows for the years then ended. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the company as at December 31, 1998 and 1997 and the results of its operations and its cash flows for the years then ended in accordance with generally accepted accounting principles.

Calgary, Alberta
April 16, 1999



HUDSON & COMPANY
Chartered Accountants

consolidated balance sheet

DECEMBER 31	1998	1997
ASSETS		
CURRENT		
Cash	\$ —	\$ 181,697
Accounts receivable	178,665	1,895
Prepaid expenses	8,790	—
	187,455	183,592
CAPITAL ASSETS (note 3)	1,119,826	—
START-UP COSTS	—	31,351
	\$ 1,307,281	\$ 214,943
LIABILITIES		
CURRENT		
Accounts payable (note 4)	\$ 116,947	\$ 5,223
Income taxes payable	36,925	—
Current portion of long-term debt	150,700	—
	304,572	5,223
BANK CREDIT FACILITY (note 5)	143,343	—
LONG-TERM DEBT (note 5)	269,457	—
FUTURE SITE RESTORATION COSTS	27,484	—
	744,856	5,223
SHAREHOLDERS' EQUITY		
SHARE CAPITAL (note 6)	603,060	210,003
RETAINED EARNINGS (DEFICIT)	(40,635)	(283)
	562,425	209,720
	\$ 1,307,281	\$ 214,943

APPROVED ON BEHALF OF THE BOARD:



T.D. Lawrence
Director



Julio Poscente
Director

consolidated statements of earnings and retained earnings (deficit)

YEARS ENDED DECEMBER 31	1998	1997
REVENUE		
Petroleum and natural gas sales	\$ 390,297	\$ —
Royalties, net of ARTC of \$24,445	(69,422)	—
Interest	5,120	2,930
	325,995	2,930
EXPENSES		
Operating costs	106,772	—
General and administration	81,324	3,213
Interest	11,267	—
Amortization and depletion	141,732	—
	341,095	3,213
Earnings (loss) before income taxes	(15,100)	(283)
INCOME TAXES (note 7)		
Income taxes	36,925	—
Deferred (recovery)	(11,673)	—
	25,252	—
NET EARNINGS (LOSS)	(40,352)	(283)
RETAINED EARNINGS (DEFICIT), beginning of year	(283)	—
RETAINED EARNINGS (DEFICIT), end of year	\$ (40,635)	\$ (283)
Basic and Fully Diluted Loss Per Share (Note 8)	\$ (0.01)	\$ —

consolidated statements of cash flows

YEARS ENDED DECEMBER 31	1998	1997
CASH FLOWS FROM OPERATING ACTIVITIES		
Net earnings (loss)	\$ (40,352)	\$ (283)
Items not affecting cash		
Amortization and depletion	141,732	—
Future site restoration costs	19,964	—
Cash flows from operations	121,344	(283)
Net change in non-cash working capital balances	(36,911)	(28,023)
	84,433	(28,306)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of capital assets	(624,038)	—
Business acquisitions (note 2(a))	(630,000)	—
Reclassification of start-up costs	31,351	—
Cash flows (used in) investing activities	(1,222,687)	—
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from long-term debt	450,000	—
Repayment of long-term debt	(29,843)	—
Issuance of share capital, net of issue costs	393,057	210,003
Cash flows from financing activities	813,214	210,003
INCREASE (DECREASE) IN CASH	(325,040)	181,697
CASH, beginning of year	181,697	—
CASH (DEFICIENCY), end of year	\$ (143,343)	\$ 181,697
Basic and Fully Diluted Cash Flow Per Share (note 8)	\$ 0.03	\$ —
CASH IS REPRESENTED BY:		
Cash	\$ —	\$ 181,697
Bank credit facility	(143,343)	—
	\$ (143,343)	\$ 181,697

notes to the consolidated financial statements

DECEMBER 31, 1998 AND 1997

GENERAL

Sheer Energy Inc. was formed at the close of business on December 31, 1998 pursuant to an amalgamation agreement between Sheer Energy Inc. and its wholly owned subsidiary, Krystal Energy Limited. Sheer Energy Inc., prior to amalgamation was registered under the Business Corporations Act (Alberta) on April 12, 1996 as a Junior Capital Pool company as defined in the Alberta Securities Commission Policy 4.11. The company completed its major transaction on September 14, 1998 (see note 2).

These financial statements include the accounts of the company for the year ended December 31, 1998 and its wholly owned subsidiary, immediately before amalgamation, Krystal Energy Limited for the period from May 1, 1998 to December 31, 1998 (see note 2(a)).

I. SIGNIFICANT ACCOUNTING POLICIES

a) Capital assets

The company follows the full cost method of accounting for oil and gas operations, whereby all costs of exploring for and developing oil and gas properties and related reserves are capitalized. Such costs include land acquisition costs, cost of drilling both productive and non-productive wells, and geological and geophysical expenses and related overhead.

Capitalized costs, excluding costs relating to unproven properties, are depleted using the unit-of-production method based on estimated proven reserves of oil and gas before royalties as determined by independent petroleum engineers. For purposes of the depletion calculation, natural gas reserves and production are converted to equivalent volumes of crude oil based on relative sales value.

The company applies a "ceiling test" to capitalized costs to ensure that the net costs capitalized do not exceed the estimated future net revenues from the production of its proven reserves, plus the cost of undeveloped lands, less impairment. Future net revenues are calculated at year end prices and include an allowance for estimated future general and administrative expenses, interest expense, income taxes, and capital expenditures.

Gains or losses on the disposition of oil and gas properties are not ordinarily recognized except under circumstances which result in a change in the depletion rate of 20% or more.

Amortization of furniture and office equipment is provided using the declining balance method at an annual rate of 20%.

b) Interest in Joint Ventures

Substantially all of the company's oil and gas exploration and development activities are conducted jointly with others and, accordingly, the financial statements reflect only the company's proportionate interest in such activities.

c) Future site restoration and abandonment costs

Site restoration and abandonment costs are provided for over the life of the estimated proven reserves on a unit-of-production basis. Costs are estimated each year by management in consultation with the company's engineers based on current regulations, costs, technology and industry standards. The period charge is expensed and actual site restoration and abandonment expenditures are charged to the accumulated provision account as incurred.

d) Measurement uncertainty

The amounts recorded for depletion, and amortization of petroleum and natural gas properties and equipment and the provision for future site restoration and abandonment costs are based on estimates. The ceiling test is based on estimates of proved reserves, production rates, oil and gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the financial statements of changes in such estimates in future periods could be significant.

e) Per share amounts

Per share amounts are calculated using the weighted average number of shares outstanding during the year. Fully diluted per share calculations reflect the exercise of options and warrants at the later of the date of issuance or the beginning of the year. Anti-dilutive options and warrants are not included in the calculation.

2. BUSINESS ACQUISITIONS

a) Effective May 1, 1998, the company acquired all of the issued and outstanding common shares of Krystal Energy Limited. The acquisition was accounted for using the purchase method with the results of operations being included from the date of acquisition:

Allocation:

Petroleum and natural gas properties	\$	501,760
Oil and gas equipment		125,440
Other, net		2,800
	\$	630,000

Purchase consideration:

Cash	\$	330,000
Long-term debt		300,000
	\$	630,000

At the close of business December 31, 1998, Krystal Energy Limited and Sheer Energy Inc. amalgamated into Sheer Energy Inc. Under the terms of the amalgamation agreement the common shareholders of old Sheer Energy Inc. were confirmed to be the same shareholders of the new Sheer Energy Inc.

b) Effective July 1, 1998, the corporation acquired substantially all the petroleum and natural gas properties of 747724 Alberta Limited. The acquisition was accounted for using the purchase method with the results of operations being included from the date of acquisition:

Net assets acquired:

Petroleum and natural gas properties	\$	460,000
Oil and gas equipment		115,000
	\$	575,000

Purchase consideration:

Cash	\$	410,000
Common shares issued - 550,000 @ \$0.30		165,000
	\$	575,000

Costs of approximately \$30,000 relating to these acquisitions have been capitalized.

3. CAPITAL ASSETS

	1998		1997	
	Cost	Accumulated Amortization	Net Book Value	
Petroleum and natural gas properties and equipment				
Producing	\$ 1,217,818	\$ 133,959	\$ 1,083,859	\$ —
Non-producing	33,690	—	33,690	—
Office furniture and fixtures	2,530	253	2,277	—
	\$ 1,254,038	\$ 134,212	\$ 1,119,826	\$ —

4. RELATED PARTY TRANSACTION

Included in accounts payable is \$10,350 owing to management for consulting services provided during the year.

5. LONG-TERM DEBT

	1998	1997
Production loan repayable in monthly payments of \$4,225 plus interest at prime plus 1%, due October 31, 2001.	\$ 286,875	\$ —
Production loan #2 repayable in monthly payments of \$8,333 plus interest at prime plus 1%, due October 31, 2001.	133,282	—
	420,157	—
Less current portion	150,700	—
	\$ 269,457	\$ —
Principal repayments due as follows:		
1999	\$ 150,700	
2000	150,700	
2001	118,757	
	\$ 420,157	

A bank credit facility to a limit of \$150,000 is available by way of account overdraft to assist with the acquisition and development of oil and gas reserves.

Collateral lodged by the company to support the bank loans is as follows:

- (i) a general security agreement providing a fixed charge over all assets;
- (ii) an assignment of all risk insurance proceeds;
- (iii) environmental indemnity

6. SHARE CAPITAL

The company has the following authorized share capital:

Unlimited number of common voting shares

Unlimited number of first preferred non-voting shares

	Number of Shares	Amount
Issued Common Shares:		
Issued on incorporation	2,100,003	\$ 210,003
Issued on initial public offering, net of share issue costs of \$46,943.	1,450,000	243,057
Issued to acquire petroleum and natural gas properties (note 2(b))	550,000	165,000
	4,100,003	\$ 618,060

Escrow shares

Included in shares issued is 2,100,000 Common Shares which are held in escrow. The first release shall not occur without written consent of the Executive Director of the Alberta Securities Commission.

Stock options

The company has established a Stock Option Plan for the benefit of directors, officers and key employees and consultants of the company. Pursuant to the Stock Option Plan, options for a total of 350,000 Common Shares were granted to directors of the company. These options may be exercised within five years of issuance at a price of \$0.20 per share. The Stock Option Plan is subject to regulatory approval. A further 5,000 options have been reserved for issuance but have not been allocated.

In connection with its initial public offering, the company granted to its agent an option to purchase up to 145,000 Common Shares at a price of \$0.20 per Common Share exercisable until September 1999.

7. INCOME TAXES

The income tax provision differs from the expected amount calculated by applying the Canadian combined Federal and Provincial tax rate of 44.6 percent as follows:

YEARS ENDED DECEMBER 31	1998	1997
Expected income tax recovery	\$ (6,735)	\$ (126)
Non-deductible crown charge and other payments	38,964	—
Federal resource allowance	(17,640)	—
Alberta Royalty Tax Credit	(25,445)	—
Non-deductible depletion	45,300	—
Other	(9,192)	126
	\$ 25,252	\$ —

Capital assets with a net book value as at December 31, 1998 of \$560,000 have a nominal value for tax purposes as a result of business acquisitions.

At December 31, 1998 the company had approximately \$570,000 of resource and other unused income tax pools available to offset future taxable income.

8. EARNINGS AND CASH FLOW PER SHARE

Basic and fully diluted per share amounts have been calculated based upon the weighted average number of shares outstanding during the year of 3,573,016.

9. FINANCIAL INSTRUMENTS

The carrying amounts of trade receivables and payables approximate their fair values due to their short-term maturity. The bank credit facility and long-term debt as stated in the financial statements approximates fair value due to the floating prime rate applied to them. Virtually all of the company's accounts receivable are with customers in the oil and gas industry and are subject to normal industry credit risks.

10. UNCERTAINTY DUE TO THE YEAR 2000 ISSUE

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date.

The effects of the Year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure, which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

11. COMPARATIVE FIGURES

Certain of the 1997 comparative figures have been reclassified to conform with the financial statement presentation adopted in 1998.

corporate information

OFFICERS AND DIRECTORS

Terrance D. Lawrence

President and Director

Dario E. Sodero

Vice President and Director

Kevin M. Maguire

Treasurer and Director

Charles S. Cook

Director

Julio Poscente

Director

William C. Ranson

Secretary

BANKERS

Hongkong Bank of Canada

333 - 5th Avenue S.W.

Calgary, Alberta T2P 3B6

STOCK EXCHANGE LISTING

The Alberta Stock Exchange

Symbol: SHU

AUDITORS

Hudson & Company

600, 1015 - 4th Street S.W.

Calgary, Alberta T2R 1J4

SOLICITORS

Ranson, Smith, Barnes

2120, 520 - 5th Avenue S.W.

Calgary, Alberta T2P 3R7

REGISTRAR AND TRANSFER AGENT

Montreal Trust Company of Canada

Calgary, Alberta

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